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REPORT

OF GOVERNOR HUGHES'
COMMITTEE
ON SPECULATION IN

SECURITIES AND COMMODITIES

June 7, 1909

REPORT

OF THE GOVERNOR'S COMMITTEE ON SPECULATION IN SECURITIES AND COMMODITIES

1909

New York, June 7, 1909.
Hon. Charles E. Hughes,
Governor, Albany, N. Y.:
Dear Sir: The committee appointed by you on December 14, 1908, to endeavor to ascertain

"what changes, if any, are advisable in the laws of the State bearing upon speculation in securities and commodities, or relating to the protection of investors, or with regard to the instrumentalities and organizations used in dealings in securities and commodities which are the subject of speculation,"

beg leave to submit the following report:
We have invited statements from those engaged in speculation and qualified to discuss its phases; we have taken testimony offered from various sources as to its objectionable features; we have considered the experience of American States and of foreign countries in their efforts to regulate speculative operations. In our inquiry we have been aided by the officials of the various exchanges, who have expressed their views both orally and in writing, and have afforded us access to their records.

The Subject in General.

Markets have sprung into being wherever buying and selling have been conducted on a large scale. Taken in charge by regular organizations and controlled by rules, such markets become exchanges. In New York city there are two exchanges dealing in securities and seven in commodities. In addition there is a security market, without fixed membership or regular officers, known as the "Curb." The exchanges dealing in commodities are incorporated, while those dealing in securities are not.

Commodities are not held for permanent investment, but are bought and sold primarily for the purpose of commercial distribution; on the other hand, securities are primarily held for investment; but both are subjects of speculation. Speculation

consists in forecasting changes of value and buying or selling in order to take advantage of them; it may be wholly legitimate, pure gambling, or something partaking of the qualities of both. In some form it is a necessary incident of productive operations. When carried on in connection with either commodities or securities it tends to steady their prices. Where speculation is free, fluctuations in prices, otherwise violent and disastrous, ordinarily become gradual and comparatively harmless. Moreover, so far as commodities are concerned, in the absence of speculation, merchants and manufacturers would themselves be forced to carry the risks involved in changes of prices and to bear them in the intensified condition resulting from sudden and violent fluctuations in value. Risks of this kind which merchants and manufacturers still have to assume are reduced in amount, because of the speculation prevailing; and many of these milder risks they are enabled, by "hedging," to transfer to others. For the merchant or manufacturer the speculator performs a service which has the effect of insurance.

In law, speculation becomes gambling when the trading which it involves does not lead, and is not intended to lead, to the actual passing from hand to hand of the property that is dealt in. Thus, in the recent case of *Hurd vs. Taylor* (181 N. Y., 231), the Court of Appeals of New York said:

"The law of this State as to the purchase and sale of stocks is well settled. The purchase of stocks through a broker, though the party ordering such purchase does not intend to hold the stocks as an investment, but expects the broker to carry them for him with the design on the part of the purchaser to sell again the stocks when their market value has enhanced is, however speculative, entirely legal. Equally so is a 'short sale,' where the seller has not the stock he assumes to sell, but borrows it and expects to replace it when the market value has declined. But to

make such transactions legal, they must contemplate an actual purchase or an actual sale of stocks by the broker, or through him. If the intention is that the so-called broker shall pay his customer the difference between the market price at which the stocks were ordered purchased and that at which they were ordered sold, in case such fluctuation is in favor of the customer, or that in case it is against the customer, the customer shall pay the broker that difference, in purchases or sales being made, the transaction is a wager and therefore illegal. Such business is merely gambling, in which the so-called commission for purchases and sales that are never made is simply the percentage which in other gambling games is reserved in favor of the keeper of the establishment."

This is also the law respecting commodity transactions.

The rules of all the exchanges forbid gambling as defined by this opinion; but they make so easy a technical delivery of the property contracted for, that the practical effect of much speculation, in point of form legitimate, is not greatly different from that of gambling. Contracts to buy may be privately offset by contracts to sell. The offsetting may be done, in a systematic way, "by clearing houses, or by 'ring settlements.'" Where deliveries are actually made, property may be temporarily borrowed for the purpose. In these ways, speculation which has the legal traits of legitimate dealing may go on almost as freely as mere wagering, and may have most of the pecuniary and immoral effects of gambling on a large scale.

A real distinction exists between speculation which is carried on by persons of means and experience, and based on an intelligent forecast, and that which is carried on by persons without these qualifications. The former is closely connected with regular business. While not uncomplicated by waste and loss, this speculation accomplishes an amount of good which offsets much of its cost. The latter does but a small amount of good and an most incalculable amount of evil. In its nature it is in the same class with gambling upon the race-track or at the roulette table, but is practised on a vast, larger scale. Its ramifications extend to all parts of the country. It involves a practical certainty of loss to those who engage in it. A continuous stream of

wealth, taken from the actual capital of innumerable persons of relatively small means, swells the income of brokers and operators dependent on this class of business; and insofar as it is consumed like most income, it represents a waste of capital. The total amount of this waste is rudely indicated by the obvious cost of the vast mechanism of brokerage and by manipulators' gains, of both of which it is a large constituent element. But for a continuous influx of new customers, replacing those whose losses force them out of the "street," this costly mechanism of speculation could not be maintained on anything like its present scale.

THE PROBLEM TO BE SOLVED.

The problem, wherever speculation is strongly rooted, is to eliminate that which is wasteful and morally destructive, while retaining and allowing free play to that which is beneficial. The difficulty in the solution of the problem lies in the practical impossibility of distinguishing what is virtually gambling from legitimate speculation. The most fruitful policy will be found in measures which will lessen speculation by persons not qualified to engage in it. In carrying out such a policy exchanges can accomplish more than legislatures. In connection with our reports on the different exchanges, as well as on the field of investment and speculation which lies outside of the exchanges, we shall make recommendations directed to the removal of various evils now existing and to the reduction of the volume of speculation of the gambling type.

The New York Stock Exchange.

The New York Stock Exchange is a voluntary association, limited to 1,100 members, of whom about 700 are active, some of them residents of other cities. Memberships are sold for about \$80,000. The Exchange as such does no business, merely providing facilities to members and regulating their conduct. The governing power is in an elected committee of forty members and is plebary in scope. The business transacted on the floor is the purchase and sale of stocks and bonds of corporations and governments. Practically all transactions must be completed by delivery and payment on the following day.

The mechanism of the Exchange, provided by its constitution and rules, is the evolution of more than a century. An organization of stock brokers existed here in 1792, acquiring more definite form in 1817. It seems certain that for a long period the members were brokers or agents only; at the present time many are principals as well as agents, trading for themselves as well as for their customers. A number of prominent capitalists hold memberships merely for the purpose of availing themselves of the reduced commission charge which the rules authorize between members.

The volume of transactions indicates that the Exchange is to-day probably the most important financial institution in the world. In the past decade the average annual sales of shares have been 196,500,000 at prices involving an annual average turnover of nearly \$15,500,000,000; bond transactions averaged about \$500,000,000. This enormous business affects the financial and credit interests of the country in so large a measure that its proper regulation is a matter of transcendent importance. While radical changes in the mechanism, which is now so nicely adjusted that the transactions are carried on with the minimum of friction, might prove disastrous to the whole country, nevertheless measures should be adopted to correct existing abuses.

PATRONS OF THE EXCHANGE.

The patrons of the Exchange may be divided into the following groups:

(1) Investors, who personally examine the facts relating to the value of securities or act on the advice of reputable and experienced financiers, and pay in full for what they buy.

(2) Manipulators, whose connection with corporations issuing or controlling particular securities enables them under certain circumstances to move the prices up or down, and who are thus in some degree protected from dangers encountered by other speculators.

(3) Floor traders, who keenly study the markets and the general conditions of business, and acquire early information concerning the changes which affect the values of securities. From their familiarity with the technique of dealings on the Exchange, and ability to act in concert with others,

and thus manipulate values, they are supposed to have special advantages over other traders.

(4) Outside operators having capital, experience, and knowledge of the general conditions of business. Testimony is clear as to the result which, in the long run, attends their operations; commissions and interest charges constitute a factor always working against them. Since good luck and bad luck alternate in time, the gains only stimulate these men to larger ventures, and they persist in them till a serious or ruinous loss forces them out of the "Street."

(5) Inexperienced persons who act on interested advice, "tips," advertisements in newspapers, or circulars sent by mail, or "take flyers" in absolute ignorance, and with blind confidence in their luck. Almost without exception they eventually lose.

CHARACTER OF TRANSACTIONS.

It is unquestionable that only a small part of the transactions upon the Exchange is of an investment character; a substantial part may be characterized as virtually gambling. Yet we are unable to see how the State could distinguish by law between proper and improper transactions, since the forms and the mechanisms used are identical. Rigid statutes directed against the latter would seriously interfere with the former. The experience of Germany with similar legislation is illuminating. But the Exchange, with the plenary power over members and their operations, could provide correctives, as we shall show.

MARGIN TRADING.

Purchasing securities on margin is as legitimate a transaction as a purchase of any other property in which part payment is deferred. We therefore see no reason whatsoever for recommending the radical change suggested, that margin trading be prohibited.

Two practices are prolific of losses, namely, buying active securities on small margins and buying unsound securities, paying for them in full. The losses in the former case are due to the quick turns in the market, to which active stocks are subject; these exhaust the margins and call for more money than the purchasers can supply. The losses in the latter case are

largely due to misrepresentations of interested parties and unscrupulous manipulations.

To correct the evils of misrepresentation and manipulation, we shall offer in another part of this report certain recommendations. Insofar as losses are due to insufficient margins, they would be materially reduced if the customary percentage of margins were increased. The amount of margin which a broker requires from a speculative buyer of stocks depends, in each case on the credit of the buyer; and the amount of credit which one person may extend to another is a dangerous subject on which to legislate. Upon the other hand, a rule made by the Exchange could safely deal with the prevalent rate of margins required from customers. In preference, therefore, to recommending legislation, we urge upon all brokers to discourage speculation upon small margins and upon the Exchange to use its influence, and, if necessary, its power, to prevent members from soliciting and generally accepting business on a less margin than 10 per cent.

PYRAMIDING.

"Pyramiding," which is the use of paper profits in stock transactions as a margin for further commitments, should be discouraged. The practice tends to produce more extreme fluctuations and more rapid wiping out of margins. If the stock brokers and the banks would make it a rule to value securities for the purpose of margin or collateral, not at the current price of the moment, but at the average price of, say, the previous two or three months (provided that such average price were not higher than the price of the moment), the dangers of pyramiding would be largely prevented.

SHORT-SELLING.

We have been strongly urged to advise the prohibition or limitation of short sales, not only on the theory that it is wrong to agree to sell what one does not possess, but that such sales reduce the market price of the securities involved. We do not think that it is wrong to agree to sell something that one does not now possess, but expects to obtain later. Contracts and agreements to sell, and deliver in the

future, property which one does not possess at the time of the contract, are common in all kinds of business. The man who has "sold short" must some day buy in order to return the stock which he has borrowed to make the short sale. Short-sellers endeavor to select times when prices seem high in order to sell, and times when prices seem low in order to buy, their action in both cases serving to lessen advances and diminish declines of price. In other words, short-selling tends to produce steadiness in prices, which is an advantage to the community. No other means of restraining unwarranted marking up and down of prices has been suggested to us.

The legislation of the State of New York on the subject of short-selling is significant. In 1812 the Legislature passed a law declaring all contracts for the sale of stocks and bonds void, unless the seller at the time was the actual owner or assignee thereof or authorized by such owner or assignee to sell the same. In 1858 this act was repealed by a statute now in force, which reads as follows:

"An agreement for the purchase, sale, transfer or delivery of a certificate or other evidence of debt, issued by the United States or by any State, or municipal or other corporation, or any share or interest in the stock of any bank, corporation or joint-stock association, incorporated or organized under the laws of the United States or of any State, is not void, or voidable, because the vendor, at the time of making such contract, is not the owner or possessor of the certificate, or certificates, or other evidence of debt, share or interest."

It has been urged that this statute "specifically legalizes stock gambling." As a matter of fact, however, the law would be precisely the same if that statute were repealed, for it is the well-settled common law of this country, as established by the decisions of the Supreme Court of the United States and of the State courts, that all contracts, other than mere wagering contracts, for the future purchase or sale of securities or commodities are valid, whether the vendor is, or is not, at the time of making such contract, the owner or possessor of the securities or commodities involved, in the absence of a statute making such contracts illegal. So far as any of these transactions are mere wagering

transactions, they are illegal, and not enforceable, as the law now stands.

It has been suggested to us that there should be a requirement either by law or by rule of the Stock Exchange, that no one should sell any security without identifying it by number or otherwise. Such a rule would cause great practical difficulties in the case of securities not present in New York at the time when the owner desires to sell them, and would increase the labor and cost of doing business. But, even if this were not the effect, the plan contemplates a restriction upon short sales, which, for the reasons set forth above, seems to us undesirable. It is true that this identification plan exists in England as to sales of bank shares (Leeman act of 1857); but it has proved a dead letter. It has also been used in times of apprehended panic upon the French Bourse, but opinions in regard to its effect there are conflicting. While some contend that it has been useful in preventing panics, others affirm that it has been used simply for the purpose of protecting bankers who were loaded down with certain securities which they were trying to distribute, and who, through political influence, procured the adoption of the rule for their special benefit.

MANIPULATION OF PRICES.

A subject to which we have devoted much time and thought is that of the manipulation of prices by large interests. This falls into two general classes:

(1) That which is resorted to for the purpose of making a market for issues of new securities.

(2) That which is designed to serve merely speculative purposes in the endeavor to make a profit as the result of fluctuations which have been planned in advance.

The first kind of manipulation has certain advantages, and when not accompanied by "matched orders" is unobjectionable *per se*. It is essential to the organization and carrying through of important enterprises, such as large corporations, that the organizers should be able to raise the money necessary to complete them. This can be done only by the sale of securities. Large blocks of securities, such as are frequently issued by railroad and other companies, cannot be

sold over the counter or directly to the ultimate investor, whose confidence in them can, as a rule, be only gradually established. They must therefore, if sold at all, be disposed of to some syndicate, who will in turn pass them on to middlemen or speculators, until, in the course of time, they find their way into the boxes of investors. But prudent investors are not likely to be induced to buy securities which are not regularly quoted on some exchange, and which they cannot sell, or on which they cannot borrow money at their pleasure. If the securities are really good and bids and offers *bona-fide*, open to all sellers and buyers, the operation is harmless. It is merely a method of bringing new investments into public notice.

The second kind of manipulation mentioned is undoubtedly open to serious criticism. It has for its object either the creation of high prices for particular stocks, in order to draw in the public as buyers and to unload upon them the holdings of the operators, or to depress the prices and induce the public to sell. There have been instances of gross and unjustifiable manipulation of securities, as in the case of American Ice stock. While we have been unable to discover any complete remedy short of abolishing the Stock Exchange itself, we are convinced that the Exchange can prevent the worst forms of this evil by exercising its influence and authority over the members to prevent them. When continued manipulation exists it is patent to experienced observers.

"WASH SALES" AND "MATCHED ORDERS."

In the foregoing discussion we have confined ourselves to *bona-fide* sales. So far as manipulation of either class is based upon fictitious or so-called "wash sales," it is open to the severest condemnation, and should be prevented by all possible means. These fictitious sales are forbidden by the rules of all the regular exchanges, and are not enforceable at law. They are less frequent than many persons suppose. A transaction must take place upon the floor of the Exchange to be reported, and if not reported does not serve the purpose of those who engage in it. If it takes place on the floor of the Exchange, but is purely a pretence, the brokers involved run the risk of detection and expulsion, which is to them a

sentence of financial death. There is, however, another class of transactions called "matched orders," which differ materially from those already mentioned, in that they are actual and enforceable contracts. We refer to that class of transactions, engineered by some manipulator, who sends a number of orders simultaneously to different brokers, some to buy and some to sell. These brokers, without knowing that other brokers have countervailing orders from the same principal, execute their orders upon the floor of the Exchange, and the transactions become binding contracts; they cause an appearance of activity in a certain security which is unreal. Since they are legal and binding, we find a difficulty in suggesting a legislative remedy. But where the activities of two or more brokers in certain securities become so extreme as to indicate manipulation rather than genuine transactions, the officers of the Exchange would be remiss unless they exercised their influence and authority upon such members in a way to cause them to desist from such suspicious and undesirable activity. As already stated, instances of continuous manipulation of particular securities are patent to every experienced observer, and could without difficulty be discouraged, if not prevented by prompt action on the part of the Exchange authorities.

CORNERS.

The subject of corners in the stock market has engaged our attention. The Stock Exchange might properly adopt a rule providing that the governors shall have power to decide when a corner exists and to fix a settlement price, so as to relieve innocent persons from the injury or ruin which may result therefrom. The mere existence of such a rule would tend to prevent corners.

FAILURES AND EXAMINATION OF BOOKS.

We have taken testimony on the subject of recent failures of brokers, where it has been discovered that they were insolvent for a long period prior to their public declaration of failure, and where their activities after their insolvency not only caused great loss to their customers, but also, owing to their efforts to save themselves from bankruptcy, worked great injury to innocent outsiders. For cases of this character, there should be a law analo-

gous to that forbidding banks to accept deposits after insolvency is known; and we recommend a statute making it a misdemeanor for a broker to receive any securities or cash from any customer (except in liquidating or fortifying an existing account), or to make any further purchases or sales for his own account, after he has become insolvent; with the provision that a broker shall be deemed insolvent when he has on his books an account or accounts which, if liquidated, would exhaust his assets, unless he can show that he had reasonable ground to believe that such accounts were good.

The advisability of requiring by State authority an examination of the books of all members of the Exchange, analogous to that required of banks, has been urged upon us. Doubtless some failures would be prevented by such a system rigidly enforced, although bank failures do occur in spite of the scrutiny of the examiners. Yet the relations between brokers and their customers are of so confidential a nature that we do not recommend an examination of their books by any public authority. The books and accounts of the members of the Exchange should, however, be subjected to periodic examination and inspection pursuant to rules and regulations to be prescribed by the Exchange, and the result should be promptly reported to the governors thereof.

It is vain to say that a body possessing the powers of the board of governors of the Exchange, familiar with every detail of the mechanism, generally acquainted with the characteristics of members, cannot improve present conditions. It is a deplorable fact that with all their power and ability to be informed, it is generally only after a member or a firm is overtaken by disaster, involving scores or hundreds of innocent persons, and causing serious disturbances, that the Exchange authorities take action. No complaint can be registered against the severity of the punishment then meted out; but in most cases the wrongdoing thus atoned for, which has been going on for a considerable period, might have been discovered under a proper system of supervision, and the vastly preponderant value of prevention over cure demonstrated.

REHYPOTHECATION OF SECURITIES.

We have also considered the subject of rehypothecating, loaning, and other use of securities by brokers who hold them for customers. So far as any broker applies to his own use any securities belonging to a customer, or hypothecates them for a greater amount than the unpaid balance of the purchase price, without the customer's consent, he is undoubtedly guilty of a conversion under the law as it exists to-day, and we call this fact to the attention of brokers and the public. When a broker sells the securities purchased for a customer who has paid therefor in whole or in part, except upon the customer's default, or disposes of them for his own benefit, he should be held guilty of larceny, and we recommend a statute to that effect.

DEALING FOR CLERKS.

The Exchange now has a rule forbidding any member to deal or carry an account for a clerk or employee of any other member. This rule should be extended so as to prevent dealing for account of any clerk or subordinate employee of any bank, trust company, insurance company, or other moneyed corporation or banker.

LISTING REQUIREMENTS.

Before securities can be bought and sold on the Exchange, they must be examined. The committee on Stock List is one of the most important parts of the organization, since public confidence depends upon the honesty, impartiality, and thoroughness of its work. While the Exchange does not guarantee the character of any securities, or affirm that the statements filed by the promoters are true, it certifies that due diligence and caution have been used by experienced men in examining them. Admission to the list, therefore, establishes a presumption in favor of the soundness of the security so admitted. Any securities authorized to be bought and sold on the Exchange, which have not been subjected to such scrutiny, are said to be in the unlisted department, and traders who deal in them do so at their own risk. We have given consideration to the subject of verifying the statements of fact contained in the papers filed with the applications for listing, but we do not recommend that either the State or the Exchange take such

responsibility. Any attempt to do so would undoubtedly give the securities a standing in the eyes of the public which would not in all cases be justified. In our judgment, the Exchange should, however, adopt methods to compel the filing of frequent statements of the financial condition of the companies whose securities are listed, including balance sheets, income and expense accounts, etc., and should notify the public that these are open to examination under proper rules and regulations. The Exchange should also require that there be filed with future applications for listing a statement of what the capital stock of the company has been issued for, showing how much has been issued for cash, how much for property, with a description of the property, etc., and also showing what commission, if any, has been paid to the promoters or vendors. Furthermore, means should be adopted for holding those making the statements responsible for the truth thereof. The unlisted department, except for temporary issues, should be abolished.

FICTITIOUS TRADES

Complaint is made that orders given by customers are sometimes not actually executed, although so reported by the broker. We recommend the passage of a statute providing that, in case it is pleaded in any suit by or against a broker that the purchase or sale was fictitious, or was not an actual bonafide purchase or sale by the broker as agent for the customer, the court or jury shall make a special finding upon that fact. In case it is found that the purchase or sale was not actual and bonafide the customer shall recover three times the amount of the loss which he sustained thereby; and copies of the finding shall be sent to the district attorney of the county and to the Exchange, if the broker be a member.

UNIT OF TRADING.

The Exchange should insist that all trading be done on the basis of a reasonably small unit (say 100 shares of stock or \$1,000 of bonds), and should not permit the offers of such lots, or bids for such lots, to be ignored by traders offering or bidding for larger amounts. The practice now permitted of allowing bids and offers for

large amounts, all or none, assists the manipulation of prices. Thus a customer may send an order to sell 100 shares of a particular stock at par, and a broker may offer to buy 1,000 shares, all or none, at 101, and yet no transaction take place. The bidder in such a case should be required to take all the shares offered at the lower price before bidding for a larger lot at a higher price. This would tend to prevent matched orders.

STOCK CLEARING HOUSE.

We have also considered the subject of the Stock Exchange Clearing House. While it is undoubtedly true that the clearing of stocks facilitates transactions which may be deemed purely manipulative, or virtually gambling transactions, nevertheless we are of the opinion that the Exchange could not do its necessary and legitimate business but for the existence of the clearing system, and, therefore, that it is not wise to abolish it.

The transactions in stocks which are cleared are transcribed each day on what are called "clearing sheets," and these sheets are passed into the Clearing House and there filed for one week only. In view of the value of these sheets as proving the transactions and the prices, they should be preserved by the Exchange for at least six years, and should be at the disposal of the courts, in case of any dispute.

SPECIALISTS.

We have received complaints that specialists on the floor of the Exchange, dealing in inactive securities, sometimes buy or sell for their own account while acting as brokers. Such acts without the principal's consent are illegal. In every such case recourse may be had to the courts.

Notwithstanding that the system of dealing in specialties is subject to abuses, we are not convinced that the English method of distinguishing between brokers and jobbers serves any better purpose than our own practice, while its introduction here would complicate business. It should also be noted that the practice of specialists in buying and selling for their own account often serves to create a market where otherwise one would not exist.

BRANCH OFFICES.

Complaint has been made of branch offices in the city of New York, often luxu-

riously furnished and sometimes equipped with lunch rooms, cards, and liquor. The tendency of many of them is to increase the lure of the ticker by the temptation of creature comforts, appealing thus to many who would not otherwise speculate. The governors of the Exchange inform us that they realize that some of these offices have brought discredit on the Exchange, and that on certain occasions they have used their powers to suppress objectionable features. It seems to us that legitimate investors and speculators might, without much hardship, be compelled to do business at the main offices, and that a hard-and-fast rule against all branch offices in the city of New York might well be adopted by the Exchange. In any event, we are convinced that a serious and effective regulation of these branch offices is desirable.

INCORPORATION OF EXCHANGE.

We have been strongly urged to recommend that the Exchange be incorporated, in order to bring it more completely under the authority and supervision of the State and the process of the courts. Under existing conditions, being a voluntary organization, it has almost unlimited power over the conduct of its members, and it can subject them to instant discipline for wrongdoing, which it could not exercise in a summary manner if it were an incorporated body. We think that such power residing in a properly chosen committee is distinctly advantageous. The submission of such questions to the courts would involve delays and technical obstacles which would impair discipline without securing any greater measure of substantial justice. While this committee is not entirely in accord on this point, no member is yet prepared to advocate the incorporation of the Exchange and a majority of us advise against it, upon the ground that the advantages to be gained by incorporation may be accomplished by rules of the Exchange and by statutes aimed directly at the evils which need correction.

The Stock Exchange in the past, although frequently punishing infractions of its rules with great severity, has, in our opinion, at times failed to take proper measures to prevent wrongdoing. This has been probably due not only to a conservative

unwillingness to interfere in the business of others, but also to a spirit of comradeship which is very marked among brokers, and frequently leads them to overlook misconduct on the part of fellow-members, although at the same time it is a matter of cynical gossip and comment in the street. The public has a right to expect something more than this from the Exchange and its members. This committee, in refraining from advising the incorporation of the Exchange, does so in the expectation that the Exchange will in the future take full advantage of the powers conferred upon it by its voluntary organization, and will be active in preventing wrongdoing such as has occurred in the past. Then we believe that there will be no serious criticism of the fact that it is not incorporated. If, however, wrongdoing recurs, and it should appear to the public at large that the Exchange has been derelict in exerting its powers and authority to prevent it, we believe that the public will insist upon the incorporation of the Exchange and its subjection to State authority and supervision.

WALL STREET AS A FACTOR.

There is a tendency on the part of the public to consider Wall Street and the New York Stock Exchange as one and the same thing. This is an error arising from their location. We have taken pains to ascertain what proportion of the business transacted on the Exchange is furnished by New York city. The only reliable sources of information are the books of the commission houses. An investigation was made of the transactions on the Exchange for a given day, when the sales were 1,500,000 shares. The returns showed that on that day 52 per cent. of the total transactions on the Exchange apparently originated in New York city, and 48 per cent. in other localities.

The Consolidated Stock Exchange.

The Consolidated Exchange was organized as a mining stock exchange in 1875, altering its name and business in 1886. Although of far less importance than the Stock Exchange, it is nevertheless a secondary market of no mean proportions; by far the greater part of the trading is in securities listed upon the main exchange, and the

prices are based upon the quotations made there. The sales average about 45,000,000 shares per annum. The fact that its members make a specialty of "broken lots," i. e., transactions in shares less than the 100 unit, is used as a ground for the claim that it is a servicable institution for investors of relatively small means. But it is obvious that its utility as a provider of capital for enterprises is exceedingly limited; and that it affords facilities for the most injurious form of speculation—that which attracts persons of small means.

It also permits dealing in shares not listed in the main exchange, and in certain mining shares, generally excluded from the other. In these cases it prescribes a form of listing requirements, but the original listing of securities is very rarely availed of. The rules also provide for dealing in grain, petroleum, and other products. Wheat is, however, at present the only commodity actively dealt in, and this is due solely to the permission to trade in smaller lots than the Produce Exchange unit of 5,000 bushels.

There are 1,225 members about 450 active, and memberships have sold in recent years at from \$650 to \$2,000. In general the methods of conducting business are similar to those of the larger exchange, and subject to the same abuses.

Very strained relations have existed between the two security exchanges since the lesser one undertook in 1886 to deal in stocks. The tension has been increased by the methods by which the Consolidated obtains the quotations of the other, through the use of the "tickers" conveying them. It is probable that without the use of these instruments the business of the Consolidated Exchange would be paralyzed; yet the right to use them rests solely upon a technical point in a judicial decision which enjoins their removal.

Cognate Subjects.

HOLDING COMPANIES.

Connected with operations on the Stock Exchange are a class of manipulations originating elsewhere. The values of railway securities, for example, depend upon the management of the companies issuing them, the directors of which may use their power to increase, diminish, or even extinguish them, while they make gains for

themselves by operations on the Exchange. They may advance the price of a stock by an unexpected dividend, or depress it by passing an expected one. They may water a stock by issuing new shares, with no proportionate addition to the productive assets of the company, or load it with indebtedness, putting an unexpected lien on the shareholders' property. Such transactions affect not only the fortunes of the shareholders, who are designedly kept in ignorance of what is transpiring, but also the value of investments in other similar companies the securities of which are affected sympathetically. Railroad wrecking was more common in the last half-century than it is now, but we have some glaring examples of it in the debris of our street railways to-day.

The existence and misuse of such powers on the part of directors are a menace to corporate property and a temptation to officials who are inclined to speculate, leading them to manage the property so as to fill their own pockets by indirect and secret methods.

A holding company represents the greatest concentration of power in a body of directors and the extreme of helplessness on the part of shareholders. A corporation may be so organized that its bonds and preferred stock represent the greater part of its capital, while the common stock represents the actual control. Then, if a second company acquires a majority of the common stock, or a majority of the shares that are likely to be voted at elections, it may control the former company, and as many other companies as it can secure. The shareholders of the subsidiary companies may be thus practically deprived of power to protect themselves against injurious measures and even to obtain information of what the holding company is doing, or intends to do, with their property.

As a first step toward mitigating this evil we suggest that the shareholders of subsidiary companies, which are dominated by holding companies, or voting trusts, shall have the same right to examine the books, records, and accounts of such holding companies, or voting trusts, that they have in respect of the companies whose shares they hold, and that the shareholders of holding companies have the same right as regards the books, records, and accounts of

the subsidiary companies. The accounts of companies not merged should be separately kept and separately stated to their individual stockholders, however few they may be.

We may point out the fact that the powers which holding companies now exercise were never contemplated, or imagined, when joint stock corporations were first legalized. If Parliament and Legislatures had foreseen their growth they would have erected barriers against it.

RECEIVERSHIPS.

Our attention has been directed to the well-known abuses frequently accompanying receiverships of large corporations, and more especially public service corporations, and the issue of receivers' certificates. We feel that the numerous cases of long-drawn-out receiverships, in some instances lasting more than ten years, and of the issue of large amounts of receivers' certificates, which take precedence over even first mortgage bonds, are deserving of most serious consideration.

Legislation providing for a short-time limitation on receiverships, or for a limitation of receivers' certificates to a small percentage of the mortgage liens on the property, could be rendered unnecessary, however, by the action of the courts themselves along these lines, so as to make impossible in the future the abuses which have been so common in the past.

EFFECT OF THE MONEY MARKET ON SPECULATION.

It has been urged that your committee consider the influence of the money market upon security speculation.

As a result of conditions to which the defects of our monetary and banking systems chiefly contribute, there is frequently a congestion of funds in New York city, when the supply is in excess of business needs and the accumulated surplus from the entire country generally is thereby set free for use in the speculative market. Thus there almost annually occurs an inordinately low rate for "call loans," at times less than one per cent. During the prevalence of this abnormally low rate speculation is unduly incited, and speculative loans are very largely expanded.

On the other hand, occasional extraordinary industrial activity, coupled with the

annually recurring demands for money during the crop-moving season, causes money stringency, and the calling of loans made to the stock market; an abnormally high interest rate results, attended by violent reaction in speculation and abrupt fall in prices. The pressure to retain funds in the speculative field at these excessively high interest rates tends to a curtailment of reasonable accommodation to commercial and manufacturing interests, frequently causing embarrassment and at times menacing a crisis.

The economic questions involved in these conditions are the subject of present consideration by the Federal authorities and the National Monetary Commission. They could not be adjusted or adequately controlled either through Exchange regulation or State legislation.

THE USURY LAW.

The usury law of this State prohibits the taking of more than 6 per cent. interest for the loan of money, but by an amendment adopted in 1882 an exception is made in the case of loans of \$5,000, or more, payable on demand and secured by collateral. It is claimed by some that, since this exception enables stock speculators, in times of great stringency, to borrow money by paying excessively high rates of interest, to the exclusion of other borrowers, a repeal of this provision would check inordinate speculation. We direct attention, however, to the fact that the statute in question excepts such loans as are secured by warehouse receipts, bills of lading, bills of exchange, and other negotiable instruments. Hence its operation is not limited to Stock Exchange transactions, or to speculative loans in general. Moreover, the repeal of the statute would affect only the conditions when high rates of interest are exacted, and not those of abnormally low rates, which really promote excessive speculation. Finally, our examination indicates that prior to the enactment of the statute of 1882 such loans were negotiated at the maximum (6 per cent.), plus a commission, which made it equivalent to the higher rate; and a repeal of the statute would lead to the resumption of this practice. Therefore, as the repeal would not be beneficial, we cannot recommend any legislation bearing upon the

interest laws of the State, unless it be the repeal of the usury law altogether, as we believe that money will inevitably seek the point of highest return for its use. In nine States of the Union there are at present no usury laws.

The Curb Market.

There is an unorganized stock market held in the open air during exchange hours. It occupies a section of Broad Street. An enclosure in the centre of the roadway is made by means of a rope, within which the traders are supposed to confine themselves, leaving space on either side for the passage of street traffic; but during days of active trading the crowd often extends from curb to curb.

There are about 200 subscribers, of whom probably 150 appear on the curb each day, and the machinery of the operations requires the presence of as many messenger boys and clerks. Such obstruction of a public thoroughfare is obviously illegal, but no attempt has been made by the city authorities to disperse the crowd that habitually assembles there.

This open-air market, we understand, is dependent for the great bulk of its business upon members of the Stock Exchange, approximately 85 per cent. of the orders executed on the curb coming from Stock Exchange houses. The Exchange itself keeps the curb market in the street, since it forbids its own members engaging in any transaction in any other security exchange in New York. If the curb were put under a roof and organized, this trading could not be maintained.

ITS UTILITY.

The curb market has existed for upwards of thirty years, but only since the great development of trading in securities began, about the year 1897, has it become really important. It affords a public market place where all persons can buy and sell securities which are not listed on any organized exchange. Such rules and regulations as exist are agreed to by common consent, and the expenses of maintenance are paid by voluntary subscription. An agency has been established by common consent through which the rules and regulations are prescribed.

This agency consists solely of an individual who, through his long association

with the curb, is tacitly accepted as arbitrar. From this source we learn that sales recorded during the year 1905 were roughly as follows:

Bonds \$66,000,000
Stocks, industrials, shares 4,770,000
Stocks, mining, shares 41,825,000

Officials' quotations are issued daily by the agency and appear in the public press. Corporations desiring their securities to be thus quoted are required to afford the agency certain information, which is, however, superficial and incomplete. There is nothing on the curb which corresponds to the listing process of the Stock Exchange. The latter, while not guaranteeing the soundness of the securities, gives a *prima facie* character to those on the list, since the stock list committee takes some pains to learn the truth. The decisions of the agent if the curb are based on insufficient data, and since much of the work relates to mining schemes in distant States and Territories, and foreign countries, the mere fact that a security is quoted on the curb should create no presumption in its favor; quotations frequently represent "wash sales," thus facilitating swindling enterprises.

EVILS OF UNORGANIZED STATUS.

Bitter complaints have reached us of frauds perpetrated upon confiding persons, who have been induced to purchase mining shares because they are quoted on the curb; these are frequently advertised in newspapers and circulars sent through the mails as so quoted. Some of these swindles have been traced to their fountain-heads by the Post Office Department, to which complaint has been made; but usually the swindler, when cornered, has settled privately with the individual whose complaint, and then the prosecution has failed for want of testimony. Meanwhile the same operations may continue in many other places, till the swindle becomes too notorious to be profitable.

Notwithstanding the lack of proper supervision and control over the admission of securities to the privilege of quotation, some of them are meritorious, and in this particular the curb performs a useful function. The existence of the cited abuses does not, in our judgment, demand the abolition of the curb market. Regulation

is, however, imperative. To require an elaborate organization similar to that existing in the Exchanges would result in the formation of another curb free from such restraint.

As has been stated, about 85 per cent. of the business of the curb comes through the offices of members of the New York Stock Exchange, but a provision of the constitution of that Exchange prohibits its members from becoming members of, or dealing on, any other organized Stock Exchange in New York. Accordingly, operators on the curb market have not attempted to form an organization. The attitude of the Stock Exchange is therefore largely responsible for the existence of such abuses as result from the want of organization of the curb market. The brokers dealing on the latter do not wish to lose their best customers, and hence they submit to these irregularities and inconveniences.

Some of the members of the Exchange dealing on the curb have apparently been satisfied with the prevailing conditions, and in their own selfish interests have maintained an attitude of indifference toward abuses. We are informed that some of the most flagrant cases of discreditable enterprises finding dealings on the curb were promoted by members of the New York Stock Exchange.

REFORMATION OF THE CURB.

The present apparent attitude of the Exchange toward the curb seems to us clearly inconsistent with its moral obligations to the community at large. Its governors have frequently avowed before this committee a purpose to cooperate to the greatest extent for the remedy of any evils found to exist in stock speculation. The curb market as at present constituted affords ample opportunity for the exercise of such helpfulness.

The Stock Exchange should compel the formulation and enforcement of such rules as may seem proper for the regulation of business on the curb, the conduct of those dealing thereon, and, particularly, for the admission of securities to quotation.

If the curb brokers were notified that failure to comply with such requirements would be followed by an application of the rule of non-intercourse, there is little

doubt that the orders of the Exchange would be obeyed. The existing connection of the Exchange gives it ample power to accomplish this, and we do not suggest anything implying a more intimate connection.

Under such regulation, the curb market might be decently housed to the relief of its members and the general public.

THE ABUSE OF ADVERTISING.

A large part of the discredit in the public mind attaching to "Wall Street" is due to frauds perpetrated on the small investor throughout the country in the sale of worthless securities by means of alluring circulars and advertisements in the newspapers. To the success of such swindling enterprises a portion of the press contributes.

Papers which honestly try to distinguish between swindling advertisements and others, may not in every instance succeed in doing so; but readiness to accept advertisements which are obviously traps for the unwary is evidence of a moral delinquency which should draw out the severest public condemnation.

So far as the press in the large cities is concerned the correction of the evil lies, in some measure, in the hands of the reputable bankers and brokers, who, by refusing their advertising patronage to newspapers notoriously guilty in this respect, could compel them to mend their ways, and at the same time prevent fraudulent schemes from deriving an appearance of merit by association with reputable names.

Another serious evil is committed by men who give standing to promotions by serving as directors without full knowledge of the affairs of the companies, and by allowing their names to appear in prospectuses without knowing the accuracy and good faith of the statements contained therein. Investors naturally and properly pay great regard to the element of personal character, both in the offering of securities and in the management of corporations, and can therefore be deceived by the names used in unsound promotions.

BRITISH SYSTEM CONSIDERED.

We have given much attention to proposals for compelling registration, by a bureau of the State government, of all cor-

porations whose securities are offered for public sale in this State, accompanied by information regarding their financial responsibility and prospects, and prohibiting the public advertisement or sale of such securities without a certificate from the bureau that the issuing company has been so registered. The object of such registration would be to identify the promoters, so that they might be readily prosecuted in case of fraud. Such a system exists in Great Britain. The British "Companies Act" provides for such registration, and the "Directors' Liability Act" regulates the other evil referred to above. Some members of your committee are of the opinion that these laws should be adopted in this country, so far as they will fit conditions here.

This would meet with some difficulties, due in part to our multiple system of State government. If the law were in force only in this State, the advertisement and sale of the securities in question would be unhindered in other markets, and companies would be incorporated in other States, in order that their directors and promoters should escape liability. The certificate of registration might be accepted by inexperienced persons as an approval by State authority of the enterprise in question. For these reasons the majority of your committee does not recommend the regulation of such advertising and sale by State legislation.

Insofar as the misuse of the post office for the distribution of swindling circulars could be regulated by the Federal authorities, the officials have been active in checking it. They inform us that vendors of worthless securities are aided materially by the opportunity to obtain fictitious price quotations for them on the New York Curb market.

LEGISLATION RECOMMENDED.

For the regulation of the advertising evils, including the vicious "tipsters" cards, we recommend an amendment to the Penal Code to provide that any person who advertises, in the public press or otherwise, or publishes, distributes or mails, any prospectus, circular, or other statement in regard to the value of any stock, bonds, or other securities, or in regard to the business affairs, property, or finan-

cial condition of any corporation, joint stock association, copartnership or individual issuing stock, bonds, or other similar securities, which contains any statement of fact which is known to such person to be false, or as to which such person has no reasonable grounds for believing it to be true, or any promises or predictions which he cannot reasonably justify, shall be guilty of a misdemeanor; and, further, that every newspaper or other publication printing or publishing such an advertisement, prospectus, circular, or other statement, shall, before printing or publishing the same, obtain from the person responsible for the same, and retain, a written and signed statement to the effect that such person accepts responsibility for the same, and for the statements of fact contained therein, which statement shall give the address, with street number, of such person; and that the publisher of any such newspaper or other publication which shall fail to obtain and retain such statement shall be guilty of a misdemeanor.

Bucket Shops.

Bucket shops are ostensibly brokerage offices, where, however, commodities and securities are neither bought nor sold in pursuance of customers' orders, the transactions being closed by the payment of gains or losses, as determined by price quotations. In other words, they are merely places for the registration of bets or wagers; their machinery is generally controlled by the keepers, who can delay or manipulate the quotations at will.

The law of this State, which took effect September 1, 1908, makes the keeping of a bucket shop a felony, punishable by fine and imprisonment, and in the case of corporations, on second offences by dissolution or expulsion from the State. In the case of individuals the penalty for a second offence is the same as for the first. These penalties are imposed upon the theory that the practice is gambling; but in order to establish the fact of gambling it is necessary, under the New York law, to show that both parties to the trade intended that it should be settled by the payment of differences and not by delivery of property. Under the law of Massachusetts it is necessary to show only that the bucket-shop

keeper so intended. The Massachusetts law provides heavier penalties for the second offence than for the first, and makes it a second offence if a bucket shop is kept open after the first conviction.

AMENDMENT OF LAW RECOMMENDED.

We recommend that the foregoing features of the Massachusetts law be adopted in this State; also that section 355 of the act of 1908 be amended so as to require brokers to furnish to their customers *in all cases*, and not merely on demand, the names of brokers from whom shares were bought and to whom they were sold; and that the following section be added to the act:

Witness's privilege.
No person shall be excused from attending and testifying, or producing any books, papers, or other documents before any court or magistrate, upon any trial, investigation, or proceeding initiated by the district attorney for a violation of any of the provisions of this chapter, upon the ground or for the reason that the testimony or evidence, documentary or otherwise, required of him may tend to convict him of a crime or to subject him to a penalty or forfeiture; but no person shall be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he may so testify or produce evidence, documentary or otherwise, and no testimony so given or produced shall be received against him upon any criminal investigation or proceeding.

There has been a sensible diminution in the number of bucket shops in New York since the act of 1908 took effect, but there is still much room for improvement.

Continuous quotations of prices from an exchange are indispensable to a bucket shop, and when such quotations are cut off this gambling ends; therefore every means should be employed to cut them off.

SALES OF QUOTATIONS.

The quotations of exchanges have been judicially determined to be their own property, which may be sold under contracts limiting their use. In addition to supplying its own members in New York city with its quotations the Stock Exchange sells them to the telegraph companies, under contracts restricting the delivery of the service in New York city to subscribers approved by a committee of the Exchange, the contracts are terminable at its option.

This restriction would imply a purpose on the part of the Exchange to prevent the use of the quotations by bucket-shop keepers. But the contracts are manifestly insufficient, in that they fail to cover the use of the service in places other than New York city; if corroboration were needed it could be found in the fact that the quotations are the basis for bucket-shop transactions in other cities. In such effort as has been made to control these quotations the Exchange has been hampered, to some extent, by the claim that telegraph companies are common carriers, and that as such they must render equal service to all persons offering to pay the regular charge therefor. This claim has been made in other States as well as in New York, and the telegraph companies have in the past invoked it as an excuse for furnishing quotations to people who were under suspicion, although it was not possible to prove that they were operating bucket shops. Recent decisions seem to hold that this claim is not well-founded. We advise that a law be passed providing that, so far as the transmission of continuous quotations is concerned, telegraph companies shall not be deemed common carriers, or be compelled against their will to transmit such quotations to any person; also a law providing that if a telegraph company has reasonable ground for believing that it is supplying quotations to a bucket shop, it be criminally liable equally with the keeper of the bucket shop. Such laws would enable these companies to refuse to furnish quotations upon mere suspicion that parties are seeking them for an unlawful business, and would compel them to refuse such service wherever there was reasonable ground for believing that a bucket shop was being conducted.

LICENSING TICKERS.

Tickers carrying the quotations should be licensed and bear a plate whereon should appear the name of the corporation, firm, or individual furnishing the service or installing the ticker, and a license number. Telegraph companies buying or transmitting quotations from the exchanges should be required to publish semi-annually the names of all subscribers to the service furnished, and the number and location of the tickers, in a newspaper of general circulation published in the city or town in which

such tickers are installed. In case the service is furnished to a corporation, firm, or person, in turn supplying the quotations to others, like particulars should be published. A record, open to public inspection, should be kept by the installing company showing the numbers and location of the tickers. Doubtless local boards of trade, civic societies, and private individuals would, if such information were within their reach, lend their aid to the authorities in the enforcement of the law.

Measures should be taken also to control the direct wire service for the transmission of quotations, and for the prompt discontinuance of such service in case of improper use thereof. In short, every possible means should be employed to prevent bucket shops from obtaining the continuous quotations, without which their deceptions could not be carried on a single day.

The Commodity Exchanges.

Of the seven commodity exchanges in the city of New York, three dealing with Produce, Cotton, and Coffee, are classed as of major importance; two organized by dealers in Fruit and Hay, are classed as minor; and two others, the Mercantile (concerned with dairy and poultry products) and the Metal (concerned with mining products) are somewhat difficult of classification, as will appear hereafter.

The Major Exchanges.

The business transacted on the three major exchanges is mainly speculative, consisting of purchases and sales for future delivery either by those who wish to eliminate risks or by those who seek to profit by fluctuations in the value of products. "Cash" or "spot" transactions are insignificant in volume.

The objects, as set forth in the charters, are to provide places for trading, establish equitable trade principles and usages, obtain and disseminate useful information, adjust controversies, and fix by-laws and rules for these purposes.

Trading in differences of price and "wash sales" are strictly prohibited under penalty of expulsion. All contracts of sale call for delivery, and unless balanced and cancelled by equivalent contracts of purchase, must be finally settled by a delivery of the merchandise against cash payment of its value as specified in the terms of the

contract; but the actual delivery may be waived by the consent of both parties. Possession is for the most part transferred from the seller to the purchaser by warehouse receipts entitling the holder to the ownership of the goods described.

DEALING IN "FUTURES."

The selling of agricultural products for future delivery has been the subject of much controversy in recent years. A measure to prohibit such selling, known as the Hach Anti-Option bill, was debated at great length in Congress during the years 1892, 1893, and 1894. Although it passed both House and Senate in different forms, it was finally abandoned by common consent. As shown hereafter, similar legislation in Germany has proved injurious; and when attempted by our States it has either resulted detrimentally or been inoperative. The subject was exhaustively considered by the Industrial Commission of Congress which in 1901 made an elaborate report (Vol. VI), showing that selling for future delivery, based upon a forecast of future conditions of supply and demand, is an indispensable part of the world's commercial machinery, by which prices are, as far as possible, equalized throughout the year to the advantage of both producer and consumer. The subject is also treated with clearness and impartiality in the Cyclopaedia of American Agriculture, in an article on "Speculation and Farm Prices"; where it is shown that since the yearly supply of wheat, for example, matures within a comparatively short period of time somebody must handle and store the great bulk of it during the interval between production and consumption. Otherwise the price will be unduly depressed at the end of one harvest and correspondingly advanced before the beginning of another.

Buying for future delivery causes advances in prices; selling short tends to restrain inordinate advances. In each case there must be a buyer and a seller and the interaction of their trading steadies prices. Speculation thus brings into the market a distinct class of people possessing capital and special training who assume the risk of holding and distributing the proceeds of the crops from one season to another with the minimum of cost to producer and consumer.

HEDGING.

A considerable part of the business done by these exchanges consists of "hedging." This term is applied to the act of a miller, for example, who is under contract to supply a given quantity of flour monthly throughout the year. In order to insure himself against loss he makes a contract with anybody whom he considers financially responsible, to supply him wheat at times and in the quantities needed. He "hedges" against a possible scarcity and consequent rise in the price of wheat. If the miller were restricted in his purchases to persons in the actual possession of wheat at the time of making the contract he would be exposed to monopoly prices. If the wheat producer were limited in his possibilities of sale to consumers only, he would be subjected to the depressing effects of a glut in the market in June and September, at times of harvest.

To the trader, manufacturer, or exporter, the act of transferring the risk of price fluctuations to other persons who are willing to assume it, has the effect of an insurance. It enables him to use all of his time and capital in the management of his own business instead of devoting some part of them to contingencies arising from unforeseen crop conditions.

ALTERNATIVE CONTRACTS.

In order to eliminate the risk of a shortage of specific grades of the merchandise thus traded in, contracts generally permit the delivery of alternative grades, within certain limits, at differential prices; and if the grade to be delivered be not suitable for the ultimate needs of the purchaser, it can under ordinary circumstances be exchanged for the grade needed, by the payment of the differential. It is true that in this exchange of grades there is sometimes a loss or a profit, owing to some unexpected diminution or excess of supply of the particular grade wanted, due to the weather or other natural causes.

Deposits of cash margins may be required mutually by members at the time of making contracts, and subsequent additional ones if market fluctuations justify. Dealings for outsiders are usually upon a 10 per cent. margin; obviously if this margin were increased generally, say to 20

per cent., a considerable part of the criticism due to losses in speculation, particularly as to the Cotton Exchange, would be eliminated.

The major part of the transactions are adjusted by clearing systems, the method most prevalent being "ring settlements," by which groups of members having buying and selling contracts for identical quantities, offset them against each other, cancelling them upon the payment of the differences in prices.

The Produce Exchange.

The New York Produce Exchange was chartered by the Legislature in 1862, under the style of the "New York Commercial Association." The charter has been amended several times; in 1907 dealing in securities, as well as in produce, was authorized. There are over 2,000 members, but a large number are inactive. Some members are also connected with the Stock and Cotton Exchanges. The business includes dealing in all grains, cottonseed oil, and a dozen or more other products; wheat is, however, the chief subject of trading, and part thereof consists of hedging by and for millers, exporters, and importers, both here and abroad. The quantity of wheat received in New York in the five years 1904-1908 averaged 21,000,000 bushels annually. No record of "cash" sales is kept. The reported sales of "futures" show in five years an annual average of 480,000,000 bushels, the year 1907 showing 610,000,000. Although some of these sales were virtually bets on price differences, all of them were contracts enforceable at law.

CLEARING SYSTEM.

The greater part of the transactions are settled by a clearing system. The Clearing Association is a separate organization, duly incorporated, with a capital of \$25,000. All members of the association must settle daily by the clearing system; other members of the Exchange may do so. The Clearing Association assumes responsibility for the trades of all its members, and accordingly controls the exaction of margins from members to each other, and may increase them at any time if the fluctuations require it. The records of the clearings show day by day the status of each member's trading—how much he may

be "long" or "short" in the aggregate. Thus the members have a system of protection against each other; the welfare of all depends upon keeping the commitments of each within safe limits. The official margin system operates as a commendable restraint upon over-speculation.

From our examination of the trading in mining stocks recently introduced, we conclude that the lack of experience of this body in this class of business has resulted in a neglect of proper safeguards to the investor and an undue incitement to speculative transactions of a gambling nature, and should not be tolerated on the Produce Exchange.

The Cotton Exchange.

The New York Cotton Exchange was incorporated by a special charter in 1871. Its membership is limited to 450. It is now the most important cotton market in the world, as it provides the means for financing about 80 per cent. of the crop of the United States and is the intermediary for facilitating its distribution. In fact, it is the world's clearing house for the staple. Traders and manufacturers in Japan, India, Egypt, Great Britain, Germany, France, and Spain, as well as the United States, buy and sell here daily and the business is still increasing.

Cotton is the basis of the largest textile industry in the world. The business is conducted on a gigantic scale in many countries, by means of vast capital, complicated machinery, and varied processes involving considerable periods of time between the raw material and the finished product. Selling for future delivery is necessary to the harmonious and uninterrupted movement of the staple from producer to consumer. Nearly all the trading, beginning with that of the planter, involves short selling. The planter sells to the dealer, the dealer to the spinner, the spinner to the weaver, the weaver to the cloth merchant, before the cotton of any crop year is picked. Dealers who take the risk of price fluctuations insure all the other members of this trading chain against losses arising therefrom and spare them the necessity of themselves being speculators in cotton. The risks connected with raising and marketing cotton must be borne by some one, and this is now done chiefly by a class

who can give their undivided attention to it.

GRADING OF COTTON.

The grading of cotton is the vital feature of the trade. When no grade is specified in the contract, it is construed to be middling. There are now eighteen grades ranging from middling stained up to fair. This classification differs somewhat from that of other markets, and last January the Department of Agriculture at Washington took up the subject of standardizing the various grades for all American markets. The New York Cotton Exchange participated in this work; a standard was thus adopted, the types of which were supplied by its classification committee. It varies but little from the one previously in use here. The samples chosen to represent the several types are now sealed, in possession of the Department of Agriculture, awaiting the action of Congress.

The cotton plant is much exposed to vicissitudes of the weather. A single storm may change the grade of the crop in large sections of the country. It becomes necessary therefore to provide some protection for traders who have made contracts to deliver a particular grade which has become scarce by an accident which could not be foreseen. For this purpose alternative deliveries are allowed by the payment of corresponding price differentials, fixed by a committee of the Exchange twice annually, in the months of September and November.

Settlements of trades may be made individually, or by groups of members, or through a clearing system, the agency of which is a designated bank near the Exchange. No record is kept of the transactions, but it is probable that for a series of years the sales have averaged fully 50,000,000 bales annually.

INDORDINATE SPECULATION.

There have been in the past, instances of excessive and unreasonable speculation upon the cotton Exchange, notably the Sully speculation of 1904. We believe that there is also a great deal of speculation of the gambling type mentioned in the introduction of this report. In our opinion, the Cotton Exchange should take measures to restrain and, so far as possible, prevent these practices, by disciplining members

who engage in them. The officers of the Exchange must in many cases be aware of these practices, and could, in our opinion, do much to discourage them.

The Coffee Exchange.

The Coffee Exchange was incorporated by special charter in 1885. It has 320 members, about 80 per cent. active.

It was established in order to supply a daily market where coffee could be bought and sold and to fix quotations therefor, in distinction from the former method of alternate glut and scarcity, with wide variations in price—in short, to create stability and certainty in trading in an important article of commerce. This it has accomplished; and it has made New York the most important primary coffee market in the United States. But there has been recently introduced a non-commercial factor known as "valorization," a governmental scheme of Brazil, by which the public treasury has assumed to purchase and hold a certain percentage of the coffee grown there, in order to prevent a decline of the price. This has created abnormal conditions in the coffee trade.

All transactions must be reported by the seller to the superintendent of the Exchange, with an exact statement of the time and terms of delivery. The record shows that the average annual sales in the past five years have been in excess of 16,000,000 bags of 250 pounds each.

Contracts may be transferred or offset by voluntary clearings by groups of members. There is no general clearing system. There is a commendable rule providing that, in case of a "corner," the officials may fix a settlement price for contracts to avoid disastrous failures.

The Other Exchanges.

Of the exchanges which we have classified as minor, those dealing with Fruit and Hay, appear to be in nowise concerned with speculation. No sales whatever are conducted on them, all transactions being consummated either in the places of business of the members or at public auction to the highest bidder. No quotations are made or published.

In the case of the other two commodity exchanges, the Mercantile and the Metal, new problems arise. Although quotations of the products appertaining to these ex-

changes are printed daily in the public press, they are not a record of actual transactions amongst members, either for immediate or future delivery.

It is true that on the Mercantile Exchange there are some desultory operations in so-called future contracts in butter and eggs, the character of which is, however, revealed by the fact that neither delivery by the seller nor acceptance by the buyer is obligatory; the contract may be voided by either party by payment of a maximum penalty of 5 per cent. There are nominal "calls," but trading is confessedly rare. The published quotations are made by a committee, the membership of which is changed periodically. That committee is actually a close corporation of the buyers of butter and eggs, and the prices really represent their views as to the rates at which the trade generally should be ready to buy from the farmers and country dealers.

Similar, but equally deceptive, is the method of making quotations on the Metal Exchange. In spite of the apparent activity of dealings in this organization in published market reports, there are no actual sales on the floor of the Metal Exchange, and we are assured that there have been none for several years. Prices are, however, manipulated up and down by a quotation committee of three, chosen annually, who represent the great metal selling agencies as their interest may appear, affording facilities for fixing prices on large contracts, mainly for the profit of a small clique, embracing, however, some of the largest interests in the metal trade.

These practices result in deceiving buyers and sellers. The making and publishing of quotations for commodities or securities by groups of men calling themselves an exchange, or by any other similar title, whether incorporated or not should be prohibited by law, where such quotations do not fairly and truthfully represent any *bona fide* transactions on such exchanges. Under present conditions, we are of the opinion that the Mercantile and Metal Exchanges do actual harm to producers and consumers, and that their charters should be repealed.

The Experience of Germany.

In 1892 a commission was appointed by the German Government to investigate the

methods of the Berlin Exchange. The regular business of this exchange embraced both securities and commodities; it was an open board where anybody, by paying a small fee could trade either for his own account, or as a broker. The broker could make such charge as he pleased for his services, there being no fixed rate of commission. Settlements took place monthly. Margins were not always required. Under these circumstances many undesirable elements gained entrance to the Exchange and some glaring frauds resulted.

The commission was composed of government officials, merchants, bankers, manufacturers, professors of political economy, and journalists. It was in session one year and seven months. Its report was completed in November, 1893. Although there had been a widespread popular demand that all short-selling should be prohibited, the commission became satisfied that such a policy would be harmful to German trade and industry, and they so reported. They were willing, however, to prohibit speculation in industrial stocks. In general the report was conservative in tone.

THE LAW OF 1896.

The Reichstag, however, rejected the bill recommended by the commission and in 1896 enacted a law much more drastic. The landowners, constituting the powerful Agrarian party, contended that short-selling lowered the price of agricultural products, and demanded that contracts on the Exchange for the future delivery of wheat and flour be prohibited. The Reichstag assented to this demand. It provided also to demand for an abatement of stock speculation, and prohibited trading on the Exchange in industrial and mining shares for future delivery. It enacted also that every person desiring to carry on speculative transactions be required to enter his name in a public register, and that speculative trades by persons not so registered should be deemed gambling contracts and void. The object of the registry was to deter the small speculators from stock gambling and restrict speculation to men of capital and character.

The results were quite different from the intention of the legislators. Very few persons registered. Men of capital and character declined to advertise themselves as speculators. The small fry found no dim-

culy in evading the law. Foreign brokers, seeing a new field of activity opened to them in Germany, flocked to Berlin and established agencies for the purchase and sale of stocks in London, Paris, Amsterdam, and New York. Seventy such offices were opened in Berlin within one year after the law was passed, and did a flourishing business. German capital was thus transferred to foreign markets. The Berlin Exchange became insignificant and the financial standing of Germany as a whole was impaired.

DETRIMENTAL CONSEQUENCES.

This, however, was not the most serious consequence of the new law. While bankers and brokers, in order to do any business at all, were required to register, their customers were not compelled to do so. Consequently the latter could speculate through different brokers on both sides of the market, pocketing their profits and withholding on their losses as gambling contracts. Numerous cases of this kind arose, and in some the plea of wagering was entered by men who had previously borne a good reputation. They had yielded to the temptation which the new law held out to them.

Another consequence was to turn over to the large banks much of the business previously done by independent houses. Persons who desired to make speculative investments in home securities applied directly to the banks, depositing with them satisfactory security for the purchases. As the German banks were largely promoters of new enterprises, they could sell the securities to their depositors and finance the enterprises with the deposits. This was a profitable and safe business in good times, but attended by dangers in periods of stringency, since the claims of depositors were payable on demand. Here again the law worked grotesquely, since customers whose names were not on the public register could, if the speculation turned

out badly, reclaim the collateral or the cash that they had deposited as security.

MODIFICATION OF LAW IN 1908.

The evil consequences of the law of 1896 brought about its partial repeal in 1908. By a law then passed the government may, in its discretion, authorize speculative transactions in industrial and mining securities of companies capitalized at not less than \$5,000,000; the Stock Exchange Register was abolished; all persons whose names were in the "Handelsregister" (commercial directory), and all persons whose business was that of dealing in securities, were declared legally bound by contracts made by them on the Exchange. It provided that other persons were not legally bound by such contracts, but if such persons made deposits of cash or collateral security for speculative contracts, they could not reclaim them on the plea that the contract was illegal.

Insofar as the Reichstag in 1896 had aimed to prevent small speculators from wasting their substance on the Exchange, it not only failed, but, as we have seen, it added a darker hue to evils previously existing.

Germany is now seeking to recover the legitimate business thrown away twelve years ago. She still prohibits short-selling of grain and flour, although the effects of the prohibition have been quite different from those which its supporters anticipated. As there are no open markets for those products, and no continuous quotations, both buyers and sellers are at a disadvantage; prices are more fluctuating than they were before the passage of the law against short-selling.

THANKS TO THE CHAMBER OF COMMERCE.

Our cordial thanks are due to the Chamber of Commerce of the State of New York, for the free use of rooms in its building for our sessions, and of its library, and other facilities.

Respectfully submitted,

MAURICE L. MUELMAN, Secretary.

HORACE WHITE, Chairman,
CHARLES A. SCHIEREN,
DAVID LEVENTHITT,
CLARK WILLIAMS,
JOHN B. CLARK,
WILLARD V. KING,
SAMUEL H. ORDWAY,
EDWARD D. PAGE,
CHARLES SPRAGUE SMITH,

ADDENDUM

THE ENGRAVING OF SECURITIES

New York, June 7, 1909.

Hon. Charles E. Hughes, Governor, Albany, N. Y.:

SIR: The committee appointed by you on the 14th of December, 1908, to make an inquiry into facts regarding speculation in securities and commodities, have received from the New York Bank Note Company a complaint that the Stock Exchange prevents any company except the American Bank Note Company from engraving any securities dealt in on that Exchange, thereby creating a hurtful monopoly. This complaint, originally addressed to yourself, was, at your instance, referred to us. As the subject matter does not strictly appertain to speculation, the committee have directed me to reply to you in a communication separate from our general report.

We have given the officers of the Stock Exchange an opportunity to reply to this complaint. They say that on several former occasions they examined the work of the New York Bank Note Company and its predecessor, the Kendall Bank Note Company, and found that it did not meet the requirements of the Exchange as to goodness of work, safeguards for plates, etc., and that the following named corporations are now eligible for such work to be used in dealings on the Stock Exchange:

American Bank Note Company, International Bank Note Company, Western Bank Note and Engraving Company of Chicago, British American Bank Note Company, for Canadian securities; Bradbury, Wilkinson & Co., London, England, for securities other than American and Canadian.

It appears to have been the practice of the American Bank Note Company or the company which now owns it, the United Bank Note Corporation, to absorb any other company that acquired the right to do work in the United States for the New York Stock Exchange. In this way the Homer-Lee Bank Note Company and the Franklin Bank Note Company were absorbed in 1904, and the International Bank Note Company and the Western Bank Note and Engraving Company in 1905, although the corporate existence of the two last-named companies is still preserved. The officers of the Exchange admit that the companies which issue securities are sufferers from this monopoly, both as to prices charged for engraving and as to promptness of delivery, and say that the Exchange would be glad to be relieved of such monopoly.

From sources not connected with any of the parties to this controversy we learn that although the Stock Exchange will accept the work of certain foreign engraving companies, they will accept it only for foreign securities, and that attempts by American corporations to avail themselves of competitive prices by securing bids from foreign engravers have been thus defeated. From this it would seem that other considerations than the goodness of the work and carefulness in guarding the plates are here operative, and that the Stock Exchange has not rid itself of the evils of monopoly. Yours very sincerely,

HORACE WHITE,
Chairman.

**END OF
TITLE**